

# Foreign Corporations with Income Effectively Connected with a U.S. Business, 1987

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For 1987, 10,500 "foreign" corporations (i.e., those incorporated abroad) reported \$61 billion of receipts generated from activities "effectively connected" with a U.S. trade or business. Overall, these companies reported a net deficit of \$162 million from these activities. Only 3,300 of these companies reported a profit, totalling \$2.2 billion. This resulted in \$589 million of tax (referred to as the "Section II" tax in this article), after the reduction of credits and the addition of small amounts of tax from recomputing prior-year investment credits [1].

## FOREIGN OPERATIONS IN THE UNITED STATES

Foreign "persons" can establish business operations in the United States through several forms, including corporations, partnerships, and joint ventures. In regard to corporations, foreigners can either gain control of an existing U.S. company, create a new U.S. company, or operate in the United States as a branch of a foreign company. This article focuses on the latter [2].

There are several factors involved in the decision of a foreign investor to operate in the United States through either a "domestic" or "foreign" corporation [3]. The U.S. tax structure is one of these factors and it is discussed next in this article for foreign corporations operating in the United States.

## U.S. TAXATION

Foreign corporations are those that are incorporated abroad. Thus, they are not created or organized in the United States, or under the laws of the United States or any of its States. These corporations are, however, subject to U.S. income tax on income "effectively connected" with the conduct of a U.S. trade or business, as well as on income from U.S. sources that is not effectively connected. There are two methods of taxation that apply, depending on whether or not the income is considered to be effectively connected with a trade or business in the United States [4].

Foreign corporations are taxed on income effectively connected with a U.S. trade or business in a manner similar to that used to tax the income of domestic corporations. This tax is referred to as "Section II" tax on Form 1120F, U.S. Income Tax Return of a Foreign Corporation. To determine the taxable income, gross income that is effectively connected with a U.S. trade or business is reduced by allowable deductions to the extent that such deductions are related to this income [5]. The same tax rates, tax methods, and credits used to reduce tax liability are available to both foreign and domestic corporations.

The Tax Reform Act of 1986 changed the regular corporate tax rates, effective July 1, 1987 [6]. For the period before this date, the rates were as follows:

<u>Taxable income</u>	<u>Tax rate</u>
\$25,000 or less .....	15%
\$25,001 to \$50,000 .....	18%
\$50,001 to \$75,000 .....	30%
\$75,001 to \$100,000 .....	40%
Over \$100,000 .....	46%

If a corporation's taxable income exceeded \$1 million, then the corporation was liable for an additional tax equal to the lesser of (a) 5 percent of the taxable income over \$1 million, or (b) \$20,250.

For the period beginning on July 1, 1987 and continuing thereafter, the corporate tax rates were changed to:

<u>Taxable income</u>	<u>Tax rate</u>
\$50,000 or less .....	15%
\$50,001 to \$75,000 .....	25%
Over \$75,000 .....	34%

If a corporation's taxable income exceeds \$100,000, then the corporation is liable for an additional tax equal to the lesser of (a) 5 percent of the taxable income over \$100,000, or (b) \$11,750.

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For accounting periods that included July 1, 1987, taxable income was subjected to both the old and new tax rates, with the resulting tax determined based on a proration of the number of days in the accounting period that fell before and after July 1. Because the statistics for 1987 shown in this article represent corporate returns with accounting periods that ended between July 1987 and June 1988 (and, thus, began as early as August 1986 for a 12-month period), the income tax amounts were calculated based on a mix of both the old and revised tax rates.

The 1986 Act also repealed the alternative tax on capital gains beginning July 1, 1987. Previously, companies with net long-term capital gains could elect to use an alternative method of tax computation if it produced a lower amount of tax than under the regular method. Under the alternative method, net long-term capital gains were taxed separately at a rate of 28 percent (34 percent for the period January 1, 1987, to July 1, 1987). The remainder of taxable income was then taxed at the regular rates. Under the 1986 Act, corporate long-term capital gains are taxed as ordinary income; there is no alternative tax computation for capital gains [7].

Credits could be used to reduce the "Section II" tax calculated under either the regular or alternative methods. These credits included, for Tax Year 1987, the foreign tax credit and the general business credit. The Tax Reform Act of 1986 made certain changes to the credits available to corporations. In addition to the regular or alternative tax after credits, a foreign corporation's "Section II" tax could include a tax from recomputing prior-year investment credits.

Fixed or determinable annual or periodic income from U.S. sources, such as interest, dividends, rents, royalties, annuities, and certain gains (such as from the sale or exchange of patents and copyrights) may or may not be effectively connected income [8]. This is determined on the basis of whether the income is from assets used in the conduct of a U.S. trade or business and whether the activities of the U.S. trade or business are a principal factor in producing the income.

A foreign corporation that disposes of U.S. real property interests must treat the gain or loss as effectively connected income, even if the corporation is not otherwise engaged in a U.S. trade or business. In addition, a foreign corporation could elect to treat certain income from U.S. real property as effectively connected income, even if it otherwise would not have been considered to be this type of income. Included were certain gross rents, royalties, and gains. This election permitted the corporation to apply deductions against this gross income. For 1987,

over 60 percent of foreign corporations with U.S. effectively connected income were classified as real estate companies. This is discussed in more detail later in this article.

Certain types of foreign-source income were also considered to be U.S. effectively connected income. For instance, interest received by a foreign bank from sources outside the United States was treated as effectively connected with the conduct of a U.S. trade or business if the bank had an office in the United States to which the income was attributable and if the interest was derived from banking activities in the United States. Because foreign income taxes were imposed on such interest, banks accounted for nearly all of the total foreign tax credit claimed by foreign corporations with U.S. effectively connected income for 1987.

As mentioned previously, foreign corporations were also taxed on U.S.-source income that was not effectively connected with the conduct of a U.S. trade or business. (This tax is referred to as "Section I" tax on Form 1120F.) This income included certain amounts of investment income, such as interest, dividends, rents, royalties, annuities, and gains from the sale or exchange of certain property (including patents, copyrights, timber and coal). Gross income in these categories was taxed at a rate of 30 percent unless the rate had been reduced as the result of a tax treaty between the United States and the foreign company's country of incorporation [9].

Basically, then, a foreign corporation's total U.S. tax was the sum of (1) the tax on income effectively connected with the conduct of a U.S. trade or business ("Section II" tax) and (2) the tax on U.S.-source income that was not effectively connected ("Section I" tax) [10]. It could also include (1) an alternative minimum tax, (2) an environmental tax, (3) a Personal Holding Company tax, and (4) branch profits and branch-level interest taxes. The environmental tax was authorized by the Superfund Amendments and Reauthorization Act of 1986. (The statistics for "Total U.S. Income Tax" shown in this article include all of the above taxes, except for the "Section I" tax, which is shown separately.)

The transfer of profits from a U.S. branch of a foreign corporation back to its main office in a foreign country was generally not subject to U.S. income tax. However, if the foreign corporation later distributed these profits as dividends and 50 percent or more of its gross income (over a 3-year period) was attributable to effectively connected income from its U.S. branch, then a portion of the distribution could become subject to a U.S. withholding tax of 30 percent. In addition, while interest paid by a U.S. branch of a foreign corporation to foreign creditors could

be a tax deduction in calculating effectively connected taxable income, this interest could also be subject to a U.S. withholding tax similar to that described for dividends. These "second-level withholding taxes" could be reduced or eliminated by U.S. income tax treaties with other countries.

The Tax Reform Act of 1986 replaced the "second-level withholding taxes" with "branch profits and branch-level interest taxes," subject to modification or elimination by tax treaties. For tax years beginning after 1986, the U.S. branch of a foreign corporation could be subject to a 30-percent tax on amounts considered to be a "dividend equivalent" and on certain "excess interest" deductions used in calculating effectively connected taxable income. Dividend equivalent is the branch's effectively connected earnings and profits for the year, reduced (or increased) by the amount of increase (or decrease) in the branch's U.S. net equity position during the tax year. Section 884 of the Internal Revenue Code specifies the branch profits and branch-level interest taxes.

Only data for the 10,478 foreign corporations which had income effectively connected with a U.S. trade or business for 1987 are included in this article. Foreign corporations with only U.S.-source investment income (i.e., income not effectively connected with a U.S. trade or business) are therefore excluded.

## GROWTH OF FOREIGN CORPORATIONS

The activity of foreign corporations in the United States has grown at a rapid pace. Total receipts of these corporations from activities effectively connected with a U.S. trade or business grew from \$21 billion for 1983 to \$61 billion for 1987, a 193 percent increase, using current dollars. This growth rate was notably higher than the 34 percent increase for all U.S. corporation income tax returns (see Figure A). It should be noted that total receipts for domestic corporations includes income from both domestic and foreign activities. Generally, it also includes investment-type income, such as interest and dividends not directly connected with a business activity. The amount of U.S. source, business-related income of domestic corporations for 1983 through 1987 was not separately reported on the corporation income tax return and, thus, not available for comparison to the U.S. effectively connected income of foreign corporations.

As a result of the growth rate of foreign corporations with U.S. effectively connected income, their share of the receipts reported on all corporate returns increased from 0.29 percent for 1983 to 0.64 percent for 1987. While

**Figure A.— Foreign Corporations with Income Effectively Connected with a U.S. Business Compared with All Corporations, 1983–1987**

[All figures are estimates based on samples—money amounts are in millions of dollars]

Year and item	All corporation income tax returns	Returns of foreign corporations with U.S. effectively connected income
<b>1987</b>		
Number of returns.....	3,612,133	10,478
Total receipts.....	9,580,721	61,004
Net income (less deficit).....	328,224	- 162
U.S. income subject to tax.....	311,841	1,647
Total U.S. income tax after credits <sup>2</sup> .....	86,989	614
<b>1986</b>		
Number of returns.....	3,428,515	11,342
Total receipts.....	8,669,379	43,626
Net income (less deficit).....	269,530	- 139
U.S. income subject to tax.....	276,173	1,818
Total U.S. income tax after credits <sup>2</sup> .....	73,876	564
<b>1985</b>		
Number of returns.....	3,277,219	11,693
Total receipts.....	8,398,278	50,909
Net income (less deficit).....	240,119	- 1,487
U.S. income subject to tax.....	266,061	1,025
Total U.S. income tax after credits <sup>2</sup> .....	63,348	362
<b>1984</b>		
Number of returns.....	3,170,743	10,905
Total receipts.....	7,800,711	43,656
Net income (less deficit).....	232,901	- 1,513
U.S. income subject to tax.....	257,054	902
Total U.S. income tax after credits <sup>2</sup> .....	63,990	317
<b>1983</b>		
Number of returns.....	2,999,071	8,001
Total receipts.....	7,135,494	20,794
Net income (less deficit).....	188,314	- 1,118
U.S. income subject to tax.....	218,686	469
Total U.S. income tax after credits <sup>2</sup> .....	51,479	152

<sup>1</sup> Table excludes foreign corporation returns with only income from U.S. sources that was not effectively connected with a U.S. trade or business. Income statement items shown in this table pertain only to the effectively connected income of foreign corporations.

<sup>2</sup> For foreign corporations, total U.S. income tax includes "Section II" tax, which was based on income effectively connected with a U.S. trade or business, as well as the Personal Holding Company tax, environmental tax, alternative minimum tax, and the branch profits and branch-level interest taxes. It excludes "Section I" tax since the income from U.S. sources is not effectively connected with the conduct of a trade or business in the United States.

these aggregate percentages are small, foreign corporations accounted for substantially larger portions of receipts for specific industries, particularly banking. This is discussed in the next section of this article.

## INDUSTRY CHARACTERISTICS

As can be seen in Figure B, the finance, insurance and real estate industrial division accounted for most of the business activity in the United States by foreign corporations. In fact, for 1987, this division accounted for 77 percent of the returns filed and 80 percent of the total receipts resulting from trade or business effectively connected with a U.S. activity.

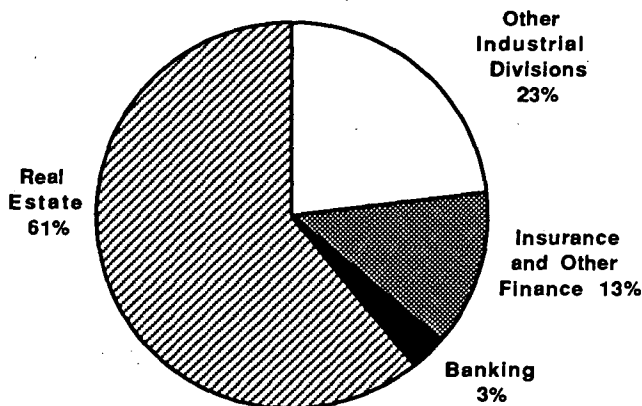
The 6,367 foreign corporations involved in real estate (61 percent of the total) generated only \$1.5 billion (or 3 percent) of total receipts. This was an average of just \$240,000 per company. As a group, foreign real estate companies reported a net deficit of \$332 million for 1987. For every company that reported a profit (i.e., net income for tax purposes), nearly three and one-half others reported losses (see Figure C).

Figure B

### Foreign Corporations with Income Effectively Connected with a U.S. Business, by Industry, 1987

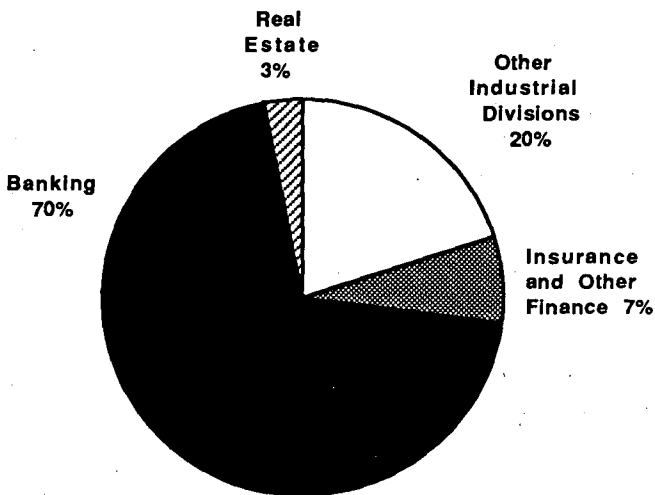
#### Number of Returns

Total: 10,478



#### Total Receipts

Total: \$61 Billion



Foreign banks in the United States reported receipts of nearly \$43 billion, or 70 percent of the total U.S. effectively connected income. Nearly all (\$37 billion) of this income was interest. Only 286 banks, 3 percent of all the foreign companies, generated these receipts for 1987.

The \$43 billion in receipts resulting from U.S. effectively connected business operations represented 11 percent of the worldwide receipts (\$395 billion) reported on all U.S.

Figure C.—Foreign Real Estate Companies with Income Effectively Connected with a U.S. Business, 1986 and 1987

[All figures are estimates based on samples—money amounts are in millions of dollars]

Item	1986	1987
Number of returns, total.....	7,110	6,367
With net income.....	2,086	1,862
Total receipts.....	2,069	1,534
Total deductions.....	2,409	1,856
Total receipts less total deductions.....	-340	-322
Net income (less deficit).....	-350	-332
Net income.....	589	238
Deficit.....	939	570
U.S. income subject to tax.....	428	124
Total U.S. income tax: <sup>1</sup>		
Before credits.....	133	47
After credits.....	131	46
Section I tax.....	5	1
Section II tax.....	130	41
Branch profits and branch-level interest taxes.....	N/A	4

<sup>1</sup> Total U.S. income tax includes "Section II" tax, which was based on income effectively connected with a U.S. trade or business, as well as the Personal Holding Company tax, environmental tax, alternative minimum tax, and the branch profits and branch-level interest taxes. It excludes "Section I" tax since the income from U.S. sources is not effectively connected with the conduct of a trade or business in the United States. "Section I" tax, however, is shown separately.

N/A - Not applicable.

corporation income tax returns with banking as their principal business activity. (Refer back to the "U.S. Taxation" section of this article for a discussion of foreign-source interest received by foreign banks which is considered to be U.S. effectively connected income.) The 1987 receipts of foreign banks in the United States represented a 63 percent increase over the \$26 billion reported for 1986.

Figure D compares foreign banks to all banks that filed U.S. income tax returns for 1987. The amount of receipts reported by foreign banks are those effectively connected with a U.S. business, while receipts reported on all U.S. income tax returns of banks represent worldwide activities. Substantially less foreign banks reported profits than did all of the banks, 38 percent compared to 68 percent. However, the 109 profitable foreign banks averaged \$15.5 million of net income, while the 8,309 total profitable banks averaged only \$2.5 million of net income. Reflecting this information, the ratios of total U.S. income tax before credits to total receipts were somewhat similar, 1.3 percent compared to 1.7 percent. After credits, the difference in the ratios of tax to receipts narrowed to 1.1 percent versus 1.3 percent. U.S. banks had substantial amounts of credits, particularly foreign tax credits.

The wholesale and retail trade industrial division was second to finance, insurance and real estate in total receipts, although it accounted for only 12 percent (or \$7.5 billion) of the total receipts of all foreign corporations. The corresponding percentage for the finance, insurance and real estate group was 80. No other industrial division represented more than 2.5 percent of the total (see Table 1).

**Figure D.—Foreign Banks with U.S. Effectively Connected Income Compared with All Banks that Filed U.S. Income Tax Returns, 1987**

[All figures are estimates based on samples—money amounts are in millions of dollars]

Item	All corporation income tax returns	Returns of foreign banks with U.S. effectively connected income
Number of returns, total	12,243	286
With net income	8,309	109
Percentage	67.9%	38.1%
Total receipts	394,678,345	42,828,676
Interest	300,518,674	36,676,217
Total deductions	371,784,728	41,783,357
Interest paid	216,656,309	35,310,938
Net income (less deficit)	14,224,568	1,028,086
Net income	20,377,186	1,693,394
Deficit	6,152,617	665,309
U.S. income subject to tax	16,830,301	1,330,199
Total U.S. income tax before credits <sup>1</sup>	6,765,723	546,353
Regular and alternative tax or Section II tax	6,484,540	533,283
Section I tax <sup>2</sup>	26,871	26,871
Total credits	1,708,449	54,479
Foreign tax credit	1,366,848	52,747
General business credit	341,270	1,732
Total U.S. income tax after credits	5,057,274	491,874
Total U.S. income tax before credits as a percentage of total receipts	1.7%	1.3%
Total U.S. income tax after credits as a percentage of total receipts	1.3%	1.1%

<sup>1</sup>For all returns, total U.S. income tax before credits includes regular and alternative taxes, Personal Holding Company taxes, taxes from recomputing prior year investment credits, environmental taxes, and alternative minimum taxes. For foreign corporations, total U.S. income tax before credits includes "Section II" tax, which is similar to the regular and alternative taxes and is based on income effectively connected with a U.S. trade or business, as well as the Personal Holding Company tax, the tax from recomputing prior year investment credit, environmental tax, and the alternative minimum tax. It also includes the branch profits and branch-level interest taxes for foreign corporations. However, it excludes "Section I" tax for these foreign companies since the income from U.S. sources is not effectively connected with the conduct of a trade or business in the United States.

<sup>2</sup>Only foreign corporations with U.S. effectively connected income could have Section I tax.

## COUNTRY CHARACTERISTICS

Nearly three-fourths of the 10,478 foreign corporations which reported income effectively connected with a U.S. trade or business for 1987 were incorporated in the ten countries shown in Table 2. These 7,592 companies also accounted for 89 percent of the effectively connected receipts of all foreign corporations operating a U.S. trade or business.

Table 2 shows that nine of the ten countries with the largest amount of U.S. effectively connected receipts were the same for 1986 and 1987. The only new country on this list was Belgium, in the tenth position, which replaced the Netherlands. Foreign corporations from Belgium accounted for \$1 billion of receipts from U.S. effectively connected business activities.

The Netherlands Antilles had the largest number of foreign-incorporated U.S. businesses, totalling 4,375, or nearly 42 percent of the total for 1987. However, these corporations accounted for only 4 percent of the effectively connected receipts of all foreign corporations. This coincided with the fact that 3,422 of these corporations were principally involved in real estate activities and produced only \$870 million of receipts (see Table 3). As

previously noted, foreign corporations involved in U.S. real estate activities tended to report relatively small amounts of receipts, as compared to those engaged in other business activities.

Japanese corporations produced the largest amount (\$21.3 billion) of U.S. effectively connected receipts for 1987. This was an increase of nearly 80 percent, up from \$11.9 billion for 1986. The majority of the receipts were produced by banks. In fact, U.S. branches of 33 Japanese banks produced \$20.8 billion of U.S. effectively connected receipts for 1987. These receipts accounted for 98 percent of the receipts of the 394 Japanese-incorporated businesses operating in the United States.

Twenty of these 33 Japanese banks produced \$661 million of taxable (net) income (i.e., "U.S. income subject to tax" in the statistics) as a result of their U.S. effectively connected business activities. (The other 13 banks reported deficits and, as a result, had no taxable income.) This U.S. taxable income resulted in \$254 million of "Section II" U.S. taxes, prior to credits. However, this amount was reduced by \$51 million of foreign tax credits and \$1 million of general business credits. The \$51 million represented over 97 percent of the total foreign tax credits claimed by all foreign corporations with income effectively

## Foreign Corporations with U.S. Operations, 1987

connected with a U.S. trade or business. The United States allowed a foreign tax credit against income tax for certain taxes paid or accrued to foreign countries. These taxes were based on the corporation's foreign-source taxable income, certain types of which were considered to be U.S. effectively connected income. (See the section entitled "U.S. Taxation.")

Canadian corporations produced the second largest amount (\$12.6 billion) of U.S. effectively connected receipts for 1987, a 174 percent increase over the 1986 amount of \$4.6 billion. Over 88 percent of these receipts were from companies classified in the finance, insurance and real estate industrial division. Banks and insurance companies accounted for most of these receipts, with \$6.8 and \$4.0 billion, respectively.

### INDUSTRY AND COUNTRY COMBINATIONS

Table 3 shows the 13 industry-country combinations with the largest total receipts for 1987. Each of these combinations had over \$500 million of U.S. effectively connected receipts. As a group, these 13 combinations accounted for 80 percent of the \$61 billion of total receipts of foreign corporations with U.S. effectively connected income.

Nine of the 13 industry-country combinations involve foreign banks, from Japan (\$20.8 billion of receipts), Canada (\$6.8 billion), Italy (\$2.2 billion), West Germany (\$2.0 billion), France (\$2.0 billion), United Kingdom (\$1.9 billion), Switzerland (\$1.2 billion), Belgium (\$1.1 billion), and Australia (\$550 million). Two of the four remaining combinations were "miscellaneous" wholesalers from Switzerland and Bermuda. Miscellaneous wholesale trade included the distribution of the following items:

- Alcoholic beverages
- Apparel, piece goods, and notions
- Chemicals and allied products
- Drugs, drug proprietaries, and druggists' sundries
- Electrical goods
- Farm-product raw materials
- Furniture and home furnishings
- Hardware, plumbing, and heating equipment and supplies
- Lumber and construction materials
- Metals and minerals, except petroleum and scrap
- Motor vehicles and automotive equipment
- Paper and paper products
- Petroleum and petroleum products
- Sporting, recreational, photographic, and hobby goods, toys, and supplies

Other nondurable goods, except groceries and related products

Other durable goods, except machinery, equipment, and supplies

The two remaining combinations were Canadian insurance companies and real estate companies from the Netherlands Antilles.

### INCOME STATEMENT AND TAX ITEMS

For 1987, the 10,478 foreign corporations reported receipts totalling \$61 billion from activities effectively connected with a trade or business in the United States. Business receipts amounted to \$20 billion, while \$38 billion of the total was interest income.

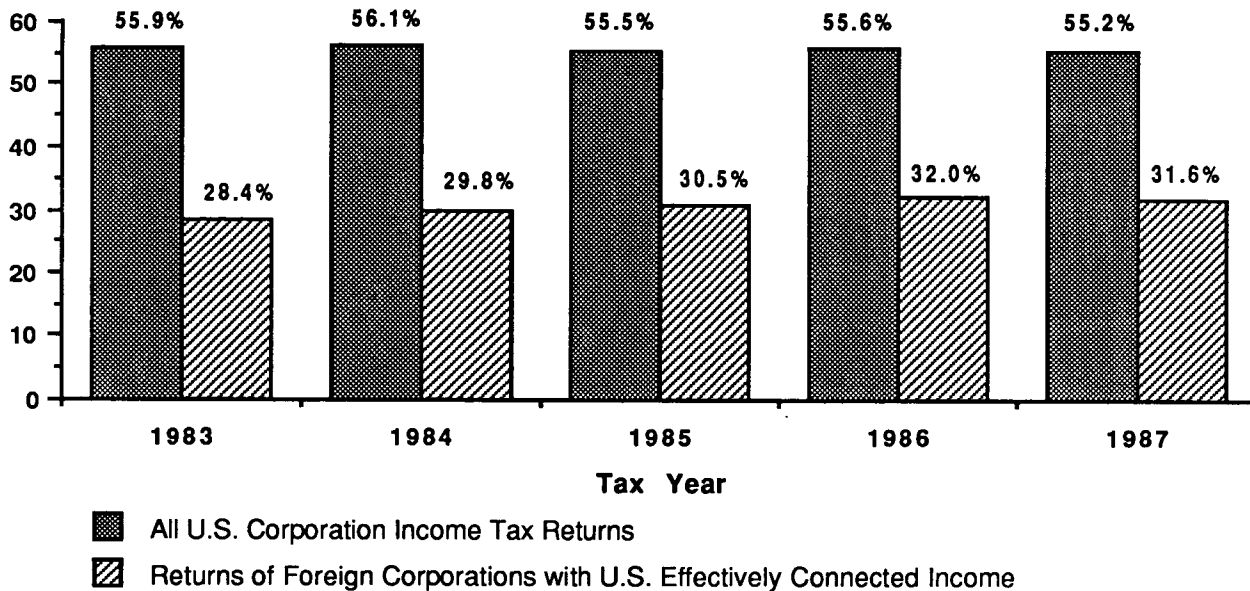
Collectively, foreign corporations claimed \$61 billion in deductions for 1987. Cost of sales and operations was \$12 billion. In conjunction with foreign banks producing large amounts of receipts in the form of interest income, they reported deductions for interest paid totalling \$35 billion. This amount was 96 percent of the \$37 billion of total interest paid by all of the foreign corporations.

Foreign corporations realized an overall net deficit of \$162 million from their effectively connected activities. This was the result of 3,306 corporations having \$2.2 billion of profits and 7,172 companies that were without profits, totalling \$2.4 billion of deficits. (A small number of these 7,172 companies were actually "breakeven" companies with equal amounts of receipts and deductions.) Thus, only 32 percent of the foreign corporations reported profits for 1987, as compared to 55 percent of all corporations filing U.S. tax returns. The percentages for 1986 were very similar to those for 1987, with only 32 percent of the foreign corporations reporting profits, compared to 56 percent for all corporations. See Figure E for a comparison of the percentages of profitable companies for the period 1983 to 1987. As can be seen in this figure, the percentage of profitable foreign corporations increased somewhat over the 5-year period.

For 1987, the profitable foreign corporations had \$1.6 billion of income subject to U.S. tax from their effectively connected activities with a U.S. trade or business. This amount was after net operating loss deductions and special deductions, and resulted in a "Section II" tax of \$645 million before credits. Tax credits of \$56 million reduced this U.S. tax liability, with foreign tax credits of \$53 million accounting for most of the credits. With the addition of small amounts of tax from recomputing prior-year investment credits, "Section II" tax totalled \$589 million. The \$589 million of tax represents less than 1 percent of the

**Figure E**  
**Percentage of Corporation Returns Reporting Net Income, 1983-1987**

[All figures are estimates based on samples]



\$61 billion of effectively connected total receipts generated by foreign corporations.

Foreign corporations with effectively connected U.S. trade and business income also incurred \$31 million of income tax on U.S.-source income that was not effectively connected with their U.S. operations (i.e., "Section I" tax), as well as \$9 million of alternative minimum tax, \$12 million of branch profits and branch-level interest taxes, and \$4 million of environmental tax. None of the foreign corporations sampled for 1987 had any Personal Holding Company tax. (While "Section I" tax is shown separately in the statistics, the income on which it was based was not tabulated.)

## SUMMARY

Foreign operations in the United States through corporations continued to grow at a relatively fast rate for 1987. While total receipts reported on all U.S. corporation income tax returns increased from 1986 to 1987 by 11 percent (using current dollars), receipts of foreign corporations with U.S. effectively connected income grew by 40 percent.

Foreign corporations with U.S. effectively connected income were largely involved in finance, insurance and

real estate activities. For 1987, this division alone accounted for 80 percent of the total receipts, with only 286 banks actually generating 70 percent of the \$61 billion of total receipts for all 10,478 foreign corporations.

Tax Year 1987 was not a very profitable year for foreign corporations with income effectively connected with a U.S. trade or business. For 1987, only 32 percent of the foreign corporations reported profits (as computed under the tax code). By comparison, 55 percent of all corporations filing U.S. tax returns reported profits for 1987.

Japanese corporations accounted for \$21 billion of the total \$61 billion of total receipts for all foreign corporations with U.S. effectively connected income. This was the largest amount of any country, with Canadian companies placing second by producing nearly \$13 billion of receipts. The receipts of Japanese and Canadian companies rose dramatically between 1986 and 1987.

## DATA SOURCES AND LIMITATIONS

### Sample

For foreign corporations with income effectively connected with a U.S. trade or business, the statistics are based primarily on samples of Forms 1120F (Return of a



Foreign Corporation). In addition to this form, the statistics include data from Form 1120L (U.S. Life Insurance Company Income Tax Return). Forms 1120L were filed by foreign companies that carried on a life insurance business in the United States. Thus, data for foreign corporations with income effectively connected with a U.S. trade or business could include information from Forms 1120L [11].

Form 1120F samples were stratified based on the size of total assets and the business activity, even though balance sheet information was not actually tabulated from Forms 1120F. The sampling rates specified for these forms were either 20 percent or 100 percent, depending on the size of total assets and the business activity. Forms 1120L were stratified based solely on the size of total assets. The sample rates specified for these forms were either 50 percent or 100 percent, depending on the size of total assets.

Because the data presented in this article are estimates based on samples, they are subject to sampling error. To properly use the data, the magnitude of the sampling error should be known. Coefficients of variation (CV's) are used to measure that magnitude. For a general discussion of CV's, see the Appendix to this publication. For a more detailed discussion of CV's, see *Statistics of Income -- 1987, Corporation Income Tax Returns*.

### Nonsampling Limitations

Most of the data in this article relate to 1987. However, for each tax year, the estimates cover returns with accounting periods that ended in a 12-month span beginning in July and ending in June. Thus, for Tax Year 1987, the span covered dates ending between July 1987 and June 1988.

As a result of the 12-month span for ending accounting periods, the statistics for each year shown in this article include income received or expenses incurred during a 23-month span. For Tax Year 1987, that span was from August 1986 through June 1988.

Each return used for the studies described in this article was given an industry code during statistical processing. This code was used as a classifier of the returns, as shown in Tables 1 and 3 of the article. (Tables 2 and 3 are classified by geographical area.) The industry code represented the principal business activity (i.e., the activity which accounted for the largest portion of total receipts) of the corporation filing the return. However, a given return may have been for a company engaged in several business activities. (In general, foreign corporations

could not be members of affiliated groups eligible to be included in consolidated returns.) To the extent that some corporations were engaged in many types of business activities, the data in this article are not entirely related to the industrial activity under which they are shown.

The income statement data for foreign corporations shown in this article are only for those corporations which had income effectively connected with a U.S. trade or business. U.S.-source investment income (including interest, dividends, rents, royalties, annuities, and other fixed or determinable annual or periodic income) that was not effectively connected with the conduct of a U.S. trade or business is excluded from the data. The tax liability on this U.S. source investment income is, however, shown separately under the heading of "Section I" tax.

### NOTES AND REFERENCES

- [1] "Section II" tax is based on a foreign corporation's income effectively connected with the conduct of a trade or business in the United States. The term "Section II" refers to the part of Form 1120F which requires information on this income.
- [2] Also see Hobbs, James R., "Domestic Corporations Controlled by Foreign Persons, 1987," *Statistics of Income Bulletin*, Summer 1990, Volume 10, Number 1.
- [3] Sections 7701(a)(4) and (5) of the Internal Revenue Code define a domestic corporation as one created or organized in the United States or under the laws of the United States or any State. A foreign corporation is one which is not domestic.
- [4] Section 864(c) of the Internal Revenue Code and the related Internal Revenue Regulations describe tests to be used in determining whether income is effectively connected with a U.S. trade or business.
- [5] Charitable contributions are deductible, subject to a limitation, whether or not they are related to effectively connected income.
- [6] For a complete discussion of this Act, see IRS Publication 921, *Explanation of the Tax Reform Act of 1986 for Business*. This Act is also discussed in *Statistics of Income -- Corporation Income Tax Returns*, for 1986 and 1987.
- [7] The Tax Reform Act of 1986 created an alternative minimum tax (AMT). Capital gains of corporations were included in the base of this tax (i.e., the alter-



native minimum taxable income). The AMT became effective for tax years beginning after December 31, 1986.

- [8] While capital gains that were considered to be effectively connected with a U.S. trade or business were taxable income, other U.S.-source capital gains were exempt from the U.S. income tax.
- [9] For a list of tax treaties, see U.S. Department of the Treasury, Internal Revenue Service, *Withholding of Tax on Nonresident Aliens and Foreign Corporations*, Publication 515.

[10] Foreign corporations are also subject to a 4 percent tax on one-half of their gross transportation income. This income is derived from the transportation of people or property that begins or ends in the United States, or from leasing or renting vessels or aircraft in such transportation. The tax is included in "Section I" tax.

[11] For 1987, the statistics may also include data from a small number of returns filed on Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return. This form was new for Tax Year 1987.

## Foreign Corporations with U.S. Operations, 1987

Table 1.—Selected Income and Tax Items, by Industrial Division, 1986 and 1987

[All figures are estimates based on samples—money amounts are in thousands of dollars]

Year and item	All industrial divisions	Agriculture, forestry, and fishing	Mining	Construction	Manufacturing	Transportation and public utilities	Wholesale and retail trade	Finance, insurance, and real estate	Services
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
<b>1987</b>									
Number of returns, total.....	10,478	330	456	94	208	247	433	8,097	567
With net income.....	3,306	86	150	47	88	*25	181	2,512	202
Total receipts.....	61,004,223	91,794	492,599	195,151	1,549,370	1,371,329	7,464,569	49,020,877	791,285
Business receipts.....	19,971,381	74,803	417,690	171,700	1,515,167	1,353,202	7,422,990	8,407,740	582,635
Interest <sup>2</sup> .....	37,934,117	4,192	27,247	7,029	5,232	*1,417	10,102	37,860,644	18,184
Total deductions.....	61,130,044	173,085	548,585	198,264	1,641,720	1,737,577	7,508,374	48,458,891	835,377
Cost of sales and operations.....	11,728,444	43,703	166,414	164,304	1,258,767	788,703	7,018,759	2,110,670	162,316
Interest paid.....	36,611,462	13,690	97,520	*8,207	37,789	78,228	38,385	36,271,749	63,884
Net income (less deficit).....	-161,948	-81,312	-56,004	-3,113	-92,350	-366,248	-43,805	525,911	-44,092
Net income.....	2,243,914	4,828	27,518	7,268	31,408	*6,481	34,487	2,097,908	33,716
U.S. income subject to tax.....	1,647,056	*2,203	*1,688	*1,361	*22,392	*5,708	13,193	1,589,956	10,262
Total U.S. income tax <sup>3</sup> .....	669,637	*642	*1,137	*463	*8,683	*2,166	9,199	643,350	3,953
Section II tax.....	644,752	*613	*524	*332	*8,316	*2,126	4,719	624,690	3,387
Branch profits and branch-level interest taxes.....	11,654	*29	*2	—	*338	40	*1,866	9,214	*164
Foreign tax credit.....	52,776	—	—	—	—	—	—	52,776	—
Other credits <sup>4</sup> .....	3,017	—	—	*5	*220	—	*263	2,521	*12
Section I tax.....	30,997	—	*5	*61	—	*478	*401	30,017	3
Distributions to stockholders except in own stock.....	107,657	*101	*634	—	—	492	*1,380	105,000	*51
<b>1986</b>									
Number of returns, total.....	11,342	309	551	77	204	144	413	8,970	592
With net income.....	3,631	75	155	*25	62	60	160	2,796	252
Total receipts.....	43,625,980	86,315	318,406	125,979	1,305,108	1,232,267	7,510,200	32,244,709	782,098
Business receipts.....	15,751,678	67,509	293,971	115,215	1,260,288	1,186,518	7,467,765	4,772,429	577,263
Interest <sup>2</sup> .....	24,292,785	5,383	2,704	3,479	6,501	*3,719	8,465	24,247,782	14,715
Total deductions.....	43,739,001	126,960	535,025	153,273	1,384,786	1,462,864	7,552,494	31,712,717	807,187
Cost of sales and operations.....	11,802,435	23,225	149,867	108,132	1,018,521	835,915	7,014,183	2,393,305	256,576
Interest paid.....	23,561,904	30,111	108,140	6,680	50,921	50,763	36,746	23,216,551	61,984
Net income (less deficit).....	-139,186	-40,654	-216,909	-27,332	-79,678	-230,597	-42,376	506,248	-25,090
Net income.....	2,492,836	5,673	8,010	*610	61,783	36,112	56,879	2,251,735	54,392
U.S. income subject to tax.....	1,817,909	*3,627	1,153	*290	50,818	26,065	24,267	1,648,834	45,196
Total U.S. income tax <sup>3</sup> .....	687,783	*1,307	423	*148	23,081	10,370	10,093	620,392	15,685
Section II tax.....	680,695	*1,307	221	*55	23,015	10,039	10,051	614,059	15,673
Foreign tax credit.....	118,341	—	—	—	—	—	*49	118,291	*1
Other credits <sup>4</sup> .....	5,794	*87	*15	—	*184	*70	*75	5,029	334
Section I tax.....	12,907	—	*7	*58	*164	*1,870	3	10,712	*9
Distributions to stockholders except in own stock.....	194,903	—	*5,756	—	*5,606	*454	*57,776	119,037	*5,403

\* Estimate should be used with caution because of the small number of returns on which it is based.

<sup>1</sup> Includes "Nature of business not allocable," which is not shown separately.<sup>2</sup> Includes taxable interest received from obligations issued by the U.S. Government, as well as taxable amounts received on loans, notes, mortgages, bank deposits, and corporate bonds.<sup>3</sup> Total U.S. income tax includes "Section II" tax, which was based on income effectively connected with a U.S. trade or business, as well as the Personal Holding Company tax, environmental tax, alternative minimum tax, and the branch profits and branch-level interest taxes (for 1987 only). It excludes "Section I" tax since the income from U.S. sources is not effectively connected with the conduct of a trade or business in the United States. "Section I" tax, however, is shown separately.<sup>4</sup> Includes nonconventional source fuel and general business credits for 1986, and just the general business credit for 1987.<sup>5</sup> Less than \$500 per return.

NOTE: Table excludes foreign corporation returns with only income from U.S. sources that was not effectively connected with a U.S. trade or business. Income statement items shown in this table pertain only to the effectively connected income of foreign corporations.

Table 2.—Selected Income and Tax Items, by Selected Country, 1986 and 1987

[All figures are estimates based on samples—money amounts are in thousands of dollars]

Year and country <sup>1</sup>	Number of returns		Total receipts	Business receipts	Total deductions	Cost of sales and operations	Net income (less deficit)	Net income
	Total	With net income						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
<b>1987</b>								
<b>All countries .....</b>	<b>10,478</b>	<b>3,306</b>	<b>61,004,223</b>	<b>19,971,381</b>	<b>61,130,044</b>	<b>11,728,444</b>	<b>- 161,948</b>	<b>2,243,914</b>
Japan.....	394	121	21,308,574	1,570,319	20,809,628	328,453	491,337	693,180
Canada.....	1,781	593	12,599,858	7,193,826	12,146,075	2,800,565	452,497	909,012
Switzerland.....	255	85	5,545,289	4,414,913	5,496,043	4,187,763	49,180	74,965
West Germany.....	230	127	3,230,388	1,209,094	3,213,583	988,671	7,122	61,178
Netherlands Antilles.....	4,375	1,186	2,636,847	1,500,968	3,030,625	796,500	- 403,409	165,117
Italy.....	15	( <sup>2</sup> )	2,202,559	26,607	2,318,968	* 5,185	- 116,409	808
United Kingdom.....	388	167	2,190,206	348,979	2,202,559	171,987	- 12,419	41,876
France.....	42	27	1,970,131	76,257	1,964,160	* 319	5,940	34,146
Bermuda.....	100	40	1,329,300	1,191,578	1,339,508	1,164,325	- 11,812	28,590
Belgium.....	* 12	* 6	* 1,078,899	* 28,124	* 1,047,689	—	* 31,210	* 32,160
<b>1986</b>								
<b>All countries .....</b>	<b>11,342</b>	<b>3,631</b>	<b>43,625,980</b>	<b>15,751,678</b>	<b>43,739,001</b>	<b>11,802,435</b>	<b>- 139,186</b>	<b>2,492,836</b>
Japan.....	283	103	11,854,703	671,223	11,102,864	289,769	751,794	853,443
Switzerland.....	271	91	4,809,878	3,704,304	4,672,352	3,428,957	135,847	289,920
Canada.....	1,641	661	4,590,725	1,715,466	4,619,331	1,147,891	- 29,038	242,919
Netherlands Antilles.....	5,226	1,389	4,376,141	3,101,630	5,156,662	2,313,831	- 794,936	288,458
West Germany.....	238	137	3,335,852	1,604,029	3,247,001	1,387,629	82,427	112,141
United Kingdom.....	407	158	2,622,554	909,573	2,624,273	604,884	- 2,017	84,804
Italy.....	25	* 3	2,154,544	97,146	2,214,644	* 71,003	- 60,100	* 9,666
France.....	43	* 20	1,832,224	98,667	1,932,071	* 12,293	- 99,848	* 5,760
Bermuda.....	107	62	1,413,057	1,367,699	1,338,930	1,231,080	74,033	91,461
Netherlands.....	208	69	587,811	54,980	485,264	* 24,374	102,547	178,538
Year and country <sup>1</sup>	U.S. income subject to tax	Total U.S. income tax <sup>2</sup>	Section II tax	Branch profits and branch-level interest taxes	Foreign tax credit	Other credits <sup>3</sup>	Section I tax	Distributions to stockholders except in own stock
	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
<b>1987</b>								
<b>All countries .....</b>	<b>1,647,056</b>	<b>669,637</b>	<b>644,752</b>	<b>11,654</b>	<b>52,776</b>	<b>3,017</b>	<b>30,997</b>	<b>107,657</b>
Japan.....	664,691	256,397	255,053	* 198	51,353	* 891	* 13,629	—
Canada.....	670,621	279,078	277,053	* 1,490	—	* 218	12,001	42,373
Switzerland.....	37,410	17,700	13,169	* 229	—	8	* 278	* 253
West Germany.....	56,981	22,379	22,288	* 4	1,366	* 183	* 1	* 47
Netherlands Antilles.....	71,951	27,179	23,882	2,385	* 13	998	829	26,644
Italy.....	—	3	—	—	—	—	—	—
United Kingdom.....	23,736	8,946	8,783	* 55	—	* 503	* 90	* 8,131
France.....	* 7,032	3,597	* 2,739	* 307	—	3	2	6,500
Bermuda.....	28,185	12,452	12,280	133	—	* 5	* 22	* 10,464
Belgium.....	—	* 771	—	—	—	—	* 3,943	—
<b>1986</b>								
<b>All countries .....</b>	<b>1,817,909</b>	<b>687,783</b>	<b>680,695</b>	<b>N/A</b>	<b>118,341</b>	<b>5,794</b>	<b>12,907</b>	<b>194,903</b>
Japan.....	745,227	302,213	300,968	N/A	111,713	* 746	* 222	* 2,408
Switzerland.....	231,742	70,021	66,314	N/A	—	* 11	* 613	* 23,120
Canada.....	204,490	87,931	87,578	N/A	* 1	285	5,737	55,096
Netherlands Antilles.....	163,107	50,437	49,741	N/A	* 573	929	1,805	27,471
West Germany.....	69,698	31,193	31,113	N/A	* 1,617	* 970	( <sup>5</sup> )	* 3,300
United Kingdom.....	28,091	12,106	12,092	N/A	2,731	* 1,749	* 26	* 6,055
Italy.....	—	—	—	N/A	—	—	151	—
France.....	* 702	* 176	* 176	N/A	—	* 16	—	—
Bermuda.....	47,847	21,607	21,601	N/A	* 46	* 13	—	* 118
Netherlands.....	165,302	49,122	48,472	N/A	—	* 251	—	* 45,246

\* Estimate should be used with caution because of the small number of returns on which it is based.

<sup>1</sup> Country is based on the location of incorporation of the foreign corporation.<sup>2</sup> Total U.S. income tax includes "Section II" tax, which was based on income effectively connected with a U.S. trade or business, as well as the Personal Holding Company tax, environmental tax, alternative minimum tax, and the branch profits and branch-level interest taxes (for 1987 only). It excludes "Section I" tax since the income from U.S. sources is not effectively connected with the conduct of a trade or business in the United States. "Section I" tax, however, is shown separately.<sup>3</sup> Includes nonconventional source fuel and general business credits for 1986, and just the general business credit for 1987.<sup>4</sup> Estimate not shown to avoid disclosure of information.<sup>5</sup> Less than \$500 per return.

N/A - Not applicable.

NOTE: Table excludes foreign corporation returns with only income from U.S. sources that was not effectively connected with a U.S. trade or business. Income statement items shown in this table pertain only to the effectively connected income of foreign corporations.

## Foreign Corporations with U.S. Operations, 1987

Table 3.—Selected Items, by Selected Industry and Country Combinations, 1987

[All figures are estimates based on samples—money amounts are in thousands of dollars]

Industry	Country <sup>1</sup>	Number of returns	Total receipts	Net income (less deficit)	Net income	U.S. income subject to tax
		(1)	(2)	(3)	(4)	(5)
<b>All industries .....</b>	<b>All countries.....</b>	<b>10,478</b>	<b>61,004,223</b>	<b>- 161,948</b>	<b>2,243,914</b>	<b>1,647,056</b>
Banking.....	Japan.....	33	20,847,742	573,829	687,462	660,586
Banking.....	Canada.....	*18	*6,770,740	*730,162	*771,931	*576,904
Miscellaneous wholesale trade .....	Switzerland.....	6	4,236,954	9,748	12,731	1,517
Insurance.....	Canada.....	*16	*3,966,671	* - 179,679	*21,963	*20,103
Banking.....	Italy.....	10	2,196,362	- 114,331	808	—
Banking.....	West Germany.....	12	2,035,273	22,357	46,413	45,234
Banking.....	France.....	9	1,958,331	2,706	27,097	—
Banking.....	United Kingdom.....	20	1,897,266	- 9,970	*20,832	*10,303
Banking.....	Switzerland.....	5	1,188,000	8,004	18,671	7,999
Miscellaneous wholesale trade .....	Bermuda.....	*7	*1,103,037	* - 11,860	*680	*680
Banking.....	Belgium.....	*7	*1,078,898	*31,234	*32,160	—
Real estate .....	Netherlands Antilles .....	3,422	870,064	- 319,793	111,949	48,281
Banking.....	Australia.....	5	553,069	10,057	12,731	6,878

Industry	Country <sup>1</sup>	Total U.S. income tax <sup>2</sup>	Section II tax	Branch profits and branch-level interest taxes	Credits <sup>3</sup>	Section I tax <sup>4</sup>
		(6)	(7)	(8)	(9)	(10)
<b>All industries .....</b>	<b>All countries.....</b>	<b>669,637</b>	<b>644,752</b>	<b>11,654</b>	<b>55,793</b>	<b>30,997</b>
Banking.....	Japan.....	255,022	253,881	—	52,237	13,172
Banking.....	Canada.....	*242,048	*242,047	—	*4	*9,474
Miscellaneous wholesale trade .....	Switzerland.....	3,408	586	214	8	5
Insurance.....	Canada.....	*7,543	*7,519	—	—	*1,437
Banking.....	Italy.....	3	—	—	—	—
Banking.....	West Germany.....	18,152	18,083	—	1,520	—
Banking.....	France.....	820	—	271	—	—
Banking.....	United Kingdom.....	*4,130	*4,044	—	*486	—
Banking.....	Switzerland.....	4,590	3,196	—	—	263
Miscellaneous wholesale trade .....	Bermuda.....	*370	*236	*133	—	—
Banking.....	Belgium.....	*771	—	—	—	*3,943
Real estate .....	Netherlands Antilles .....	17,984	15,828	2,038	*733	565
Banking.....	Australia.....	2,968	2,941	—	117	—

\* Estimate should be used with caution because of the small number of returns on which it is based.

<sup>1</sup> Country is based on the location of incorporation of the foreign corporation.<sup>2</sup> Total U.S. income tax includes "Section II" tax, which was based on income effectively connected with a U.S. trade or business, as well as the Personal Holding Company tax, environmental tax, alternative minimum tax, and the branch profits and branch-level interest taxes.<sup>3</sup> Includes foreign tax and general business credits.<sup>4</sup> "Section I" tax is excluded from total U.S. income tax since the income from U.S. sources is not effectively connected with the conduct of a trade or business in the United States.

NOTE: Table excludes foreign corporation returns with only income from U.S. sources that was not effectively connected with a U.S. trade or business. Income statement items shown in this table pertain only to the effectively connected income of foreign corporations.